

(d) *Recovery of increase to adjusted tax basis.* Any increase to the adjusted tax basis of partnership property under paragraph (c)(1) of this section is recovered using any applicable recovery period and depreciation (or other cost recovery) method (including first-year conventions) available to the partnership for newly purchased property (of the type adjusted) placed in service at the time of the distribution.

(e) *Examples.* The following examples illustrate the rules of this section. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Partner's basis in distributed property. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$5,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes \$5,000 of gain under section 737, an amount equal to the excess distribution of \$5,000 (\$10,000 fair market value of Property B less \$5,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$5,000 (\$10,000 fair market value of Property A less \$5,000 adjusted tax basis of such property).

(iii) A's adjusted tax basis in A's partnership interest is increased by the \$5,000 of gain recognized under section 737. This increase is taken into account in determining A's basis in the distributed property. Therefore, A's adjusted tax basis in distributed Property B is \$10,000 under section 732(b).

Example 2. Partner's basis in distributed property in connection with gain recognized under section 704(c)(1)(B). (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable real property located in the United States to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$10,000	5,000
Property A2	10,000	2,000

(ii) B contributes \$10,000 cash and Property B, nondepreciable real property located outside the United States, with a fair market value and adjusted tax basis of \$10,000. C contributes \$20,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in a current distribution and Property A1 is distributed to B in a current distribution. A recognizes \$5,000 of gain under section 704(c)(1)(B) and § 1.704-4 on the distribution of Property A1 to B, the difference between the fair market value of such property (\$10,000) and the adjusted tax basis in distributed Property A1 (\$5,000). The adjusted tax basis of A's partnership interest is increased by this \$5,000 of gain under section 704(c)(1)(B) and § 1.704-4(e)(1).

(iv) The increase in the adjusted tax basis of A's partnership interest is taken into account in determining the amount of the excess distribution. As a result, there is no excess distribution because the fair market value of Property B (\$10,000) is less than the adjusted tax basis of A's interest in the partnership at the time of distribution (\$12,000). A therefore recognizes no gain under section 737 on the receipt of Property B. A's adjusted tax basis in Property B is \$10,000 under section 732(a)(1). The adjusted tax basis of A's partnership interest is reduced from \$12,000 to \$2,000 under section 733. See *Example 3* of § 1.737-1(e).

Example 3. Partnership's basis in partnership property after a distribution with section 737 gain. (i) On January 31, 1995, A, B, and C form partnership ABC as equal partners. A contributes the following nondepreciable property to the partnership:

	Fair market value	Adjusted tax basis
Property A1	\$1,000	\$500
Property A2	4,000	1,500
Property A3	4,000	6,000
Property A4	6,000	4,000

(ii) The character of gain or loss on Properties A1, A2, and A3 is long-term, U.S.-source capital gain or loss. The character of gain on Property A4 is long-term, foreign-source capital gain. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$15,000. C contributes \$15,000 cash.

(iii) On December 31, 1998, Property B is distributed to A in complete liquidation of A's interest in the partnership. A recognizes gain of \$3,000 under section 737, an amount equal to the excess distribution of \$3,000 (\$15,000 fair market value of Property B less \$12,000 adjusted tax basis in A's partnership interest) and A's net precontribution gain of \$3,000 (\$15,000 aggregate fair market value of the property contributed by A less \$12,000 aggregate adjusted tax basis of such property).

(iv) \$2,000 of A's gain is long-term, foreign-source capital gain (\$3,000 total gain under

section 737 x \$2,000 net long-term, foreign-source capital gain/\$3,000 total net precontribution gain). \$1,000 of A's gain is long-term, U.S.-source capital gain (\$3,000 total gain under section 737 x \$1,000 net long-term, U.S.-source capital gain/\$3,000 total net precontribution gain).

(v) The partnership must increase the adjusted tax basis of the property contributed by A by \$3,000. All property contributed by A is eligible property. Properties A1, A2, and A3 have the same character and are grouped into a single group for purposes of allocating this basis increase. Property A4 is in a separate character group.

(vi) \$2,000 of the basis increase must be allocated to long-term, foreign-source capital assets because \$2,000 of the gain recognized by A was long-term, foreign-source capital gain. The adjusted tax basis of Property A4 is therefore increased from \$4,000 to \$6,000. \$1,000 of the increase must be allocated to Properties A1 and A2 because \$1,000 of the gain recognized by A is long-term, U.S.-source capital gain. No basis increase is allocated to Property A3 because its fair market value is less than its adjusted tax basis. The \$1,000 basis increase is allocated between Properties A1 and A2 based on the unrealized appreciation in each asset before such basis adjustment. As a result, the adjusted tax basis of Property A1 is increased by \$167 (\$1,000 x \$500/\$3,000) and the adjusted tax basis of Property A2 is increased by \$833 (\$1,000 x \$2,500/\$3,000).

[T.D. 8642, 60 FR 66736, Dec. 26, 1995; 61 FR 7214, Feb. 27, 1996]

§ 1.737-4 Anti-abuse rule.

(a) *In general.* The rules of section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 must be applied in a manner consistent with the purpose of section 737. Accordingly, if a principal purpose of a transaction is to achieve a tax result that is inconsistent with the purpose of section 737, the Commissioner can recast the transaction for federal tax purposes as appropriate to achieve tax results that are consistent with the purpose of section 737. Whether a tax result is inconsistent with the purpose of section 737 must be determined based on all the facts and circumstances. See § 1.704-4(f) for an anti-abuse rule and examples in the context of section 704(c)(1)(B). The anti-abuse rule and examples under section 704(c)(1)(B) and § 1.704-4(f) are relevant to section 737 and §§ 1.737-1, 1.737-2, and 1.737-3 to the extent that the net precontribution gain for purposes of section 737 is determined by reference to section 704(c)(1)(B).

(b) *Examples.* The following examples illustrate the rules of this section. The examples set forth below do not delineate the boundaries of either permissible or impermissible types of transactions. Further, the addition of any facts or circumstances that are not specifically set forth in an example (or the deletion of any facts or circumstances) may alter the outcome of the transaction described in the example. Unless otherwise specified, partnership income equals partnership expenses (other than depreciation deductions for contributed property) for each year of the partnership, the fair market value of partnership property does not change, all distributions by the partnership are subject to section 737, and all partners are unrelated.

Example 1. Increase in distributee partner's basis by temporary contribution; results inconsistent with the purpose of section 737. (i) On January 1, 1995, A, B, and C form partnership ABC as equal partners. A contributes Property A1, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B contributes Property B, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$10,000. C contributes \$10,000 cash.

(ii) On January 1, 1999, pursuant to a plan a principal purpose of which is to avoid gain under section 737, A transfers to the partnership Property A2, nondepreciable real property with a fair market value and adjusted tax basis of \$9,000. A treats the transfer as a contribution to the partnership pursuant to section 721 and increases the adjusted tax basis of A's partnership interest from \$1,000 to \$10,000. On January 1, 1999, the partnership agreement is amended and all other necessary steps are taken so that substantially all of the economic risks and benefits of Property A2 are retained by A. On February 1, 1999, Property B is distributed to A in a current distribution. If the contribution of Property A2 is treated as a contribution to the partnership for purposes of section 737, there is no excess distribution because the fair market value of distributed Property B (\$10,000) does not exceed the adjusted tax basis of A's interest in the partnership (\$10,000), and therefore section 737 does not apply. A's adjusted tax basis in distributed Property B is \$10,000 under section 732(a)(1) and the adjusted tax basis of A's partnership interest is reduced to zero under section 733.

(iii) On March 1, 2000, A receives Property A2 from the partnership in complete liquidation of A's interest in the partnership. A recognizes no gain on the distribution of Property A2 because the property was previously contributed property. See § 1.737-2(d).

(iv) Although A has treated the transfer of Property A2 as a contribution to the partnership that increased the adjusted tax basis of A's interest in the partnership, it would be inconsistent with the purpose of section 737 to recognize the transfer as a contribution to the partnership. Section 737 requires recognition of gain when the value of distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. Section 737 assumes that any contribution or other transaction that affects a partner's adjusted tax basis in the partnership interest is a contribution or transaction in substance and is not engaged in with a principal purpose of avoiding recognition of gain under section 737. Because the transfer of Property A2 to the partnership was not a contribution in substance and was made with a principal purpose of avoiding recognition of gain under section 737, the Commissioner can disregard the contribution of Property A2 for this purpose. As a result, A recognizes gain of \$9,000 under section 737 on the receipt of Property B, an amount equal to the lesser of the excess distribution of \$9,000 (\$10,000 fair market value of distributed Property B less the \$1,000 adjusted tax basis of A's partnership interest, determined without regard to the transitory contribution of Property A2) or A's net precontribution gain of \$9,000 on Property A1.

Example 2. Increase in distributee partner's basis; section 752 liability shift; results consistent with the purpose of section 737. (i) On January 1, 1995, A and B form general partnership AB as equal partners. A contributes Property A, nondepreciable real property with a fair market value of \$10,000 and an adjusted tax basis of \$1,000. B contributes Property B, nondepreciable real property with a fair market value and adjusted tax basis of \$10,000. The partnership also borrows \$10,000 on a recourse basis and purchases Property C. The \$10,000 liability is allocated equally between A and B under section 752, thereby increasing the adjusted tax basis in A's partnership interest to \$6,000.

(ii) On December 31, 1998, the partners agree that A is to receive Property B in a current distribution. If A were to receive Property B at that time, A would recognize \$4,000 of gain under section 737, an amount equal to the lesser of the excess distribution of \$4,000 (\$10,000 fair market value of Property B less \$6,000 adjusted tax basis in A's partnership interest) or A's net precontribution gain of \$9,000 (\$10,000 fair market value of Property A less \$1,000 adjusted tax basis of Property A).

(iii) With a principal purpose of avoiding such gain, A and B agree that A will be solely liable for the repayment of the \$10,000 partnership liability and take the steps necessary so that the entire amount of the liability is allocated to A under section 752. The adjusted tax basis in A's partnership in-

terest is thereby increased from \$6,000 to \$11,000 to reflect A's share of the \$5,000 of liability previously allocated to B. As a result of this increase in A's adjusted tax basis, there is no excess distribution because the fair market value of distributed Property B (\$10,000) is less than the adjusted tax basis of A's partnership interest. Recognizing A's increased adjusted tax basis as a result of the shift in liabilities is consistent with the purpose of section 737 and this section. Section 737 requires recognition of gain only when the value of the distributed property exceeds the distributee partner's adjusted tax basis in the partnership interest. The \$10,000 recourse liability is a bona fide liability of the partnership that was undertaken for a substantial business purpose and A's and B's agreement that A will assume responsibility for repayment of that debt has substance. Therefore, the increase in A's adjusted tax basis in A's interest in the partnership due to the shift in partnership liabilities under section 752 is respected, and A recognizes no gain under section 737.

[T.D. 8642, 60 FR 66738, Dec. 26, 1995]

§ 1.737-5 Effective date.

Sections 1.737-1, 1.737-2, 1.737-3, and 1.737-4 apply to distributions by a partnership to a partner on or after January 9, 1995.

[T.D. 8642, 60 FR 66739, Dec. 26, 1995]

TRANSFERS OF INTERESTS IN A PARTNERSHIP

§ 1.741-1 Recognition and character of gain or loss on sale or exchange.

(a) The sale or exchange of an interest in a partnership shall, except to the extent section 751(a) applies, be treated as the sale or exchange of a capital asset, resulting in capital gain or loss measured by the difference between the amount realized and the adjusted basis of the partnership interest, as determined under section 705. For treatment of selling partner's distributive share up to date of sale, see section 706(c)(2). Where the provisions of section 751 require the recognition of ordinary income or loss with respect to a portion of the amount realized from such sale or exchange, the amount realized shall be reduced by the amount attributable under section 751 to unrealized receivables and substantially appreciated inventory items, and the adjusted basis of the transferor partner's interest in the partnership shall be reduced by the

portion of such basis attributable to such unrealized receivables and substantially appreciated inventory items. See section 751 and § 1.751-1.

(b) Section 741 shall apply whether the partnership interest is sold to one or more members of the partnership or to one or more persons who are not members of the partnership. Section 741 shall also apply even though the sale of the partnership interest results in a termination of the partnership under section 708(b). Thus, the provisions of section 741 shall be applicable (1) to the transferor partner in a 2-man partnership when he sells his interest to the other partner, and (2) to all the members of a partnership when they sell their interests to one or more persons outside the partnership.

(c) See section 351 for nonrecognition of gain or loss upon transfer of a partnership interest to a corporation controlled by the transferor.

(d) For rules relating to the treatment of liabilities on the sale or exchange of interests in a partnership see §§ 1.752-1 and 1.1001-2.

[T.D. 6500, 25 FR 11814, Nov. 26, 1960; 25 FR 14021, Dec. 31, 1960, as amended by T.D. 7741, 45 FR 81745, Dec. 12, 1980]

§ 1.742-1 Basis of transferee partner's interest.

The basis to a transferee partner of an interest in a partnership shall be determined under the general basis rules for property provided by part II (section 1011 and following), subchapter O, chapter 1 of the Code. Thus, the basis of a purchased interest will be its cost. The basis of a partnership interest acquired from a decedent is the fair market value of the interest at the date of his death or at the alternate valuation date, increased by his estate's or other successor's share of partnership liabilities, if any, on that date, and reduced to the extent that such value is attributable to items constituting income in respect of a decedent (see section 753 and paragraph (c)(3)(v) of § 1.706-1 and paragraph (b) of § 1.753-1) under section 691. See section 1014(c). For basis of contributing partner's interest, see section 722. The basis so determined is then subject to the adjustments provided in section 705.

§ 1.743-1 Optional adjustment to basis of partnership property.

(a) *General rule.* The basis of partnership property shall not be adjusted as the result of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, unless the election provided by section 754 (relating to optional adjustment to basis of partnership property) is in effect with respect to the partnership. However, whether or not the election provided in section 754 is in effect, the basis of partnership property shall not be adjusted as the result of a contribution of property, including money, to the partnership.

(b) *Adjustment to basis of partnership property—(1) Determination of adjustment.* In the case of a transfer of an interest in a partnership, either by sale or exchange or as a result of the death of a partner, a partnership as to which the election under section 754 is in effect shall:

(i) Increase the adjusted basis of partnership property by the excess of the transferee's basis for his partnership interest over his share of the adjusted basis to the partnership of all partnership property, or

(ii) Decrease the adjusted basis of partnership property by the excess of the transferee partner's share of the adjusted basis of all partnership property over his basis for his partnership interest.

The amount of the increase or decrease constitutes an adjustment affecting the basis of partnership property with respect to the transferee partner only. Thus, for purposes of depreciation, depletion, gain or loss, and distributions, the transferee partner will have a special basis for those partnership properties which are adjusted under section 743(b) and this paragraph. This special basis is his share of the common partnership basis (i.e., the adjusted basis of such properties to the partnership without regard to any special basis adjustments of any transferee) plus or minus his special basis adjustments. A partner's share of the adjusted basis of partnership property is equal to the sum of his interest as a partner in partnership capital and surplus, plus his share of partnership liabilities. Where

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an agreement with respect to contributed property is in effect under section 704(c)(2), such agreement shall be taken into account in determining a partner's share of the adjusted basis of partnership property. Generally, if a partner's interest in partnership capital and profits is one-third, his share of the adjusted basis of partnership property will be one-third of such basis. The provisions of this paragraph may be illustrated by the following examples:

Example 1. A is a member of partnership ABC in which the partners have equal interests in capital and profits. The partnership has made the election under section 754, relating to the optional adjustment to the basis of partnership property. A sells his interest to P for \$22,000. The balance sheet of the partnership at the date of sale shows the following:

ASSETS		
	Adjusted basis per books	Market value
Cash	\$5,000	\$5,000
Accounts receivable	10,000	10,000
Inventory	20,000	21,000
Depreciable assets	20,000	40,000
Total	55,000	76,000

LIABILITIES AND CAPITAL		
	Adjusted basis per books	Value
Liabilities	\$10,000	\$10,000
Capital:		
A	15,000	22,000
B	15,000	22,000
C	15,000	22,000
Total	55,000	76,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and his share of the adjusted basis of partnership property. Under section 742, the basis of P's interest is \$25,333 (the cash paid for A's interest, \$22,000, plus \$3,333, P's share of partnership liabilities). P's share of the adjusted basis of partnership property is \$18,333, i.e., \$15,000 plus \$3,333. The amount to be added to the basis of partnership property is, therefore, \$7,000, the difference between \$25,333 and \$18,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755-1.

Example 2. D is a member of partnership DEF in which the partners have equal interests in profits, but not in capital. The partnership has made the election under section

754. D dies and his interest passes to W, his widow. The balance sheet of the partnership at the date of D's death shows the following:

ASSETS		
	Adjusted basis per books	Market value
Cash	\$7,000	\$7,000
Accounts receivable	10,000	10,000
Inventory	20,000	24,000
Depreciable assets	20,000	40,000
Total	57,000	81,000

LIABILITIES AND CAPITAL		
	Adjusted basis per books	Value
Liabilities	\$10,000	\$10,000
Capital:		
D	18,000	26,000
E	15,000	23,000
F	14,000	22,000
Total	57,000	81,000

The amount of the adjustment under section 743(b) is the difference between the basis of the transferee's interest in the partnership and her share of the adjusted basis of partnership property. Under section 742, the basis of W's interest is \$29,333 (the fair market value of D's interest at his death, \$26,000, plus \$3,333, his share of partnership liabilities). W's share of the adjusted basis of partnership property is \$21,333 (i.e., \$18,000 plus \$3,333, her share of partnership liabilities). The amount to be added to the basis of partnership property is, therefore, \$8,000, the difference between \$29,333 and \$21,333. This amount will be allocated to partnership properties in accordance with the rules set forth in section 755 and § 1.755-1.

Note that in examples 1 and 2 of this subparagraph the amount of the adjustment does not depend upon the adjusted basis to the transferor for his interest in partnership capital.

(2) *Determination of partner's share of adjusted basis of partnership property.* (i) Under the provisions of section 743(b), a partner's share of the adjusted basis of partnership property shall be determined by taking into account the effect of any partnership agreement with respect to contributed property as described in section 704(c)(2), or the effect of the contribution of undivided interests under section 704(c)(3). This rule may be illustrated by the following examples:

Example 1. A, B, and C form partnership ABC, to which A contributes land worth \$1,000 (property X) with an adjusted basis to him of \$400, and B and C each contributes \$1,000 cash. Each partner has \$1,000 credited to him on the books of the partnership as his capital contribution. The partners share in profits equally. During the partnership's first taxable year, property X appreciates in value to \$1,300. A sells his one-third interest in the partnership to D for \$1,100, when the election under section 754 is in effect. No agreement under section 704(c)(2) is in effect. The adjusted basis of the partnership property is increased with respect to D by the excess of his basis for his partnership interest, \$1,100, over his share of the adjusted basis of partnership property, \$800 (1/3 of \$2,400, the total adjusted basis of partnership property). The amount of the adjustment, therefore, is \$300 (\$1,100 minus \$800), which is an increase in the basis of partnership property with respect to D only. This special basis adjustment will be allocated to property X. (See section 755 and § 1.755-1.) If property X is sold for \$1,600, the gain to the partnership is \$1,200 (\$1,600 received, less the adjusted common partnership basis of \$400 for property X). Thus, each partner's distributive share of the gain on the sale is \$400. However, D's recognized gain is only \$100 (his \$400 distributive share of the gain, reduced by \$300, his special basis adjustment with respect to property X). If D purchased his interest from B or C, the partners who contributed cash, D's adjustment under section 743(b) would also be \$300, computed in exactly the same manner as in the case of a purchase from A.

Example 2. Assume that partnership ABC described in example 1 of this subdivision has an agreement under section 704(c)(2) with respect to property X, stating that upon the sale of that property any gain, to the extent attributable to the precontribution appreciation of \$600 (the difference between its value, \$1,000, and its basis, \$400, at the time of the contribution) is to be allocated entirely to A, who contributed property X. Upon the purchase of A's interest by D for \$1,100, the computation of D's special basis would differ from that indicated in example 1 of this subdivision as follows: Under the partnership agreement, A's share of the \$2,400 adjusted basis of partnership property is only \$400 (his basis for property X prior to its contribution to the partnership), and B's and C's share is \$1,000 each (the amount of the cash investment of each). The amount of the increase to D in the adjusted basis of partnership property under section 743(b)(1) is \$700 (the excess of \$1,100, D's cost basis for his interest, over \$400, A's share of the adjusted basis of partnership property to which D succeeds). This amount constitutes an adjustment to the basis of partnership property with respect to D only. If X is sold by the partnership for \$1,600, the gain is \$1,200 (\$1,600 received less

the adjusted common partnership basis of \$400). Under the partnership agreement, \$600 of this gain, which is attributable to precontribution appreciation in value, is allocable to D, who is A's successor. The remaining \$600 gain is not subject to the agreement and is allocable to the partners equally, \$200 each. D's distributive share of the partnership gain is thus \$600 plus \$200, or \$800. However, D has a special basis adjustment of \$700 under section 743(b)(1), which reduces his gain from \$800 to \$100. B and C each has a gain of \$200, which is unaffected by the transfer of A's interest to D.

Example 3. Assume the same facts as in example 2 of this subdivision, except that D has purchased his interest from B instead of from A. His special basis adjustment for partnership property in this case differs from that where he had purchased his interest from A, because of the effect of the agreement under section 704(c)(2). In this case, D is a successor to B, whose share of the adjusted basis of partnership property is \$1,000, instead of A, whose share is only \$400. As a result, the adjustment under section 743(b)(1) is the excess of D's cost basis for his interest, \$1,100, over his share of the adjusted basis of partnership property, \$1,000, or \$100. In this case, if property X is sold for \$1,600, the partnership gain is \$1,200 (\$1,600 less the adjusted partnership basis of \$400). Of this gain, \$600, representing precontribution appreciation, is allocable to A under the partnership agreement. The remaining \$600 is allocable in the amount of \$200 to each partner. Since D as a transferee has a special basis adjustment of \$100 under section 743(b)(1), his gain is reduced from \$200 to \$100.

(ii) If a partner receives a distribution of property with respect to which another partner has a special basis adjustment, the distributee shall not take into account the special basis adjustment of the other partner. However, the partner with the special basis adjustment will reallocate it under section 755 to remaining partnership property of a like kind or, if he receives a distribution of like property, to such distributed property. If a partner receives a distribution of property with respect to which he has a special basis adjustment, such basis adjustment will be taken into account when relevant under section 732. See paragraph (b) of § 1.732-2. If, at the time a partner receives property (whether or not he has a special basis adjustment with respect to such property), he relinquishes his interest in other property of a like kind with respect to which he has a special basis adjustment, the adjusted

basis to the partnership of the distributed property shall include his special basis adjustment for the property in which he relinquished his interest. For the purposes of the preceding sentence, a partner will be considered as having relinquished his interest in any remaining partnership properties when his interest has been completely liquidated; however, when a partner receives a distribution not in liquidation, he will be considered as relinquishing his interest only in property distributed to other partners. For the purposes of this subdivision, like property means property of the same class, that is, stock in trade, property used in the trade or business, capital assets, etc. For certain adjustments to the basis of remaining partnership property after a distribution to a transferee partner, see paragraph (b) of § 1.734-2. The provisions of this subdivision may be illustrated by the following examples:

Example 1. C is a transferee partner in partnership BC. The partnership owns, among other assets, X, a depreciable asset with a common basis to the partnership of \$1,000

and a special basis adjustment to C of \$200, and Y, another depreciable asset with a common basis of \$800 and a special basis adjustment to C of \$300. B and C agree that B will receive a distribution of property Y, and C will receive a distribution of property X, with all other property to remain in the partnership. With respect to B, the partnership basis of property Y is \$800, the common partnership basis. Y will, therefore, have a basis of \$800 in B's hands under section 732(a) which provides for the use of a carryover basis in the case of current distributions. With respect to C, however, the partnership basis of property X is \$1,500, the common partnership basis of \$1,000, plus C's special basis adjustment of \$200 for property X, plus C's additional special basis adjustment of \$300 for property Y, in which he has relinquished his interest.

Example 2. (a) Partner D acquired his one-third interest in partnership BCD for \$14,000 from a previous partner when an election under section 754 was in effect. Therefore, under section 743(b), D has a special basis adjustment for certain partnership property. Assume that at the time of the distribution in paragraph (b) of this example, the partnership assets consist of cash and rental property and that such assets and D's special basis adjustments under section 743(b) are as follows:

Item	Fair market value	Common partnership basis	D's share	D's special basis adjustment	Partnership basis to D
Cash	\$12,000	\$12,000	\$4,000	.....	\$4,000
House:					
U	9,000	1,200	400	.....	400
V	6,000	4,500	1,500	.....	1,500
W	8,000	1,500	500	.....	500
X	9,000	4,800	1,600	\$2,000	3,600
Y	9,000	6,000	2,000	.....	2,000
Z	7,000	3,000	1,000	1,000	2,000
Total	60,000	33,000	11,000	3,000	14,000

(b) Assume further that D receives \$4,000 in cash and houses Y and Z in complete liquidation of his interest in partnership BCD. In determining the basis to D of houses Y and Z under section 732 (b) and (c), D must allocate \$10,000 basis (\$14,000 basis for his interest, less \$4,000 cash received) to houses Y and Z in proportion to their adjusted basis to the partnership. For purposes of section 732(c), the adjusted basis of house Y is \$7,200. (\$6,000 common partnership basis, plus \$1,200, allocated share of D's special basis adjustment of \$2,000 for house X, in which D relinquished his interest). The adjusted basis of house Z is \$4,800 (\$3,000 common partnership basis, plus \$1,000, D's special basis for house Z, plus \$800, allocated share of D's special basis of \$2,000

for house X, in which D relinquished his interest). Under the rule of this subdivision, 6,000/10,000 of the \$2,000 special basis adjustment for X is allocated to Y and 4,000/10,000 of such amount to Z. Therefore, \$6,000 basis (7,200/12,000 of \$10,000) is allocated to house Y and \$4,000 basis (4,800/12,000 of \$10,000) to house Z.

(c) Since houses Y and Z had \$12,000 basis to the partnership, as computed in paragraph (b) of this example, and only \$10,000 basis to D, as determined under section 732, the partnership, under section 734(b)(1)(B), must increase the basis of remaining partnership property (houses U, V, W, and X) by \$2,000 (excess of \$12,000 over \$10,000). For allocation of this amount, see section 755 and § 1.755-1.

(iii) Where an adjustment is made under section 743(b) to the basis of partnership property subject to depletion, any depletion allowable shall be determined separately for each partner, including the transferee partner, based on his interest in such property. See paragraph (a)(8) of § 1.702-1. This rule may be illustrated by the following example:

Example. A, B, and C each contributes \$5,000 cash to form partnership ABC, which purchases oil property for \$15,000. C subsequently sells his partnership interest to D for \$100,000 when the election under section 754 is in effect. D has a special basis adjustment for the oil property of \$95,000 (the difference between D's basis, \$100,000, and his share of the basis of partnership property, \$5,000). Assume that the depletion allowance computed under the percentage method would be \$21,000 for the taxable year so that each partner would be entitled to \$7,000 as his share of the deduction for depletion. However, under the cost depletion method, at an assumed rate of 10 percent, the allowance with respect to D's one-third interest which has a basis to him of \$100,000 (\$5,000, plus his special basis adjustment of \$95,000) is \$10,000, although the cost depletion allowance with respect to the one-third interest of A and B in the oil property, each of which has a basis of \$5,000, is only \$500. For partners A and B, the percentage depletion is greater than cost depletion and each will deduct \$7,000 based on the percentage depletion method. However, as to D, the transferee partner, the cost depletion method results in a greater allowance and D will, therefore, deduct \$10,000 based on cost depletion. See section 613(a).

(iv) Where there has been more than one transfer of partnership interests, the last transferee's special basis adjustment, if any, under section 743(b) shall be determined by reference to the partnership common basis for its property without regard to any prior transferee's special basis adjustment. For example, A, B, and C form a partnership. A and B each contributes \$1,000 cash and C contributes land with a basis and value of \$1,000. When the land has appreciated in value to \$1,300, A sells his interest to D for \$1,100 (1/3 of \$3,300, the value of the partnership property). The election under section 754 is in effect; therefore, D has a special basis adjustment of \$100 with respect to the land under section 743(b). After the land has further appreciated in value to \$1,600, D sells his interest to

E for \$1,200 (1/3 of \$3,600, the value of the partnership property). Under section 743(b), E has a special basis adjustment of \$200. This amount is determined without regard to any special basis adjustment that D may have had in the partnership assets.

(3) *Returns.* A transferee partner who has a special basis adjustment under section 743(b) shall attach a statement to his income tax return for the first taxable year in which the basis of any partnership property subject to the adjustment is pertinent in determining his income tax, showing the computation of the adjustment and the partnership properties to which the adjustment has been allocated.

(c) *Allocation of basis.* For the allocation of basis among partnership properties where section 743 (b) applies, see section 755 and § 1.755-1.

PROVISIONS COMMON TO PART II,
SUBCHAPTER K, CHAPTER 1 OF THE CODE

§ 1.751-1 Unrealized receivables and inventory items.

(a) *Sale or exchange of interest in a partnership—(1) Character of amount realized.* To the extent that money or property received by a partner in exchange for all or part of his partnership interest is attributable to his share of the value of partnership unrealized receivables or substantially appreciated inventory items, the money or fair market value of the property received shall be considered as an amount realized from the sale or exchange of property other than a capital asset. The remainder of the total amount realized on the sale or exchange of the partnership interest is realized from the sale or exchange of a capital asset under section 741. For definition of "unrealized receivables" and "inventory items which have appreciated substantially in value", see section 751 (c) and (d). Unrealized receivables and substantially appreciated inventory items are hereafter in this section referred to as "section 751 property". See paragraph (e) of this section.

(2) *Determination of gain or loss.* The income or loss realized by a partner upon the sale or exchange of his interest in section 751 property is the difference between (i) the portion of the

total amount realized for the partnership interest allocated to section 751 property, and (ii) the portion of the selling partner's basis for his entire interest allocated to such property. Generally, the portion of the total amount realized which the seller and the purchaser allocate to section 751 property in an arm's length agreement will be regarded as correct. The portion of the partner's adjusted basis for his partnership interest to be allocated to section 751 property shall be an amount equal to the basis such property would have had under section 732 (including subsection (d) thereof) if the selling partner had received his share of such properties in a current distribution made immediately before the sale. See §§ 1.732-1 and 1.732-2. Such basis shall reflect the rules of section 704(c)(3), if applicable, or any agreement under section 704(c)(2). Any gain or loss recognized which is attributable to section 751 property will be ordinary gain or loss. The difference between the remainder, if any, of the partner's adjusted basis for his partnership interest and the balance, if any, of the amount realized is the transferor's capital gain or loss on the sale of his partnership interest.

(3) *Statement required.* A transferor partner selling or exchanging any part of his interest in a partnership which has any section 751 property at the time of sale or exchange shall submit with his income tax return for the taxable year in which the sale or exchange occurs a statement setting forth separately the following information:

(i) The date of the sale or exchange, the amount of the transferor partner's adjusted basis for his partnership interest, and the portion thereof attributable to section 751 property under section 732; and

(ii) The amount of any money and the fair market value of any other property received or to be received for the transferred interest in the partnership, and the portion thereof attributable to section 751 property.

(iii) If the transferor partner computes his adjusted basis for section 751 property under the provisions of section 732(d), he must also include in the statement the information required by paragraph (d)(3) of § 1.732-1.

(iv) If the transferor partner has a special basis adjustment under section 743(b), he must also include in the statement the computation of his special basis adjustment and the partnership properties to which the adjustment has been allocated.

(b) *Certain distributions treated as sales or exchanges*—(1) *In general.* (i) Certain distributions to which section 751(b) applies are treated in part as sales or exchanges of property between the partnership and the distributee partner, and not as distributions to which sections 731 through 736 apply. A distribution treated as a sale or exchange under section 751(b) is not subject to the provisions of section 707(b). Section 751(b) applies whether or not the distribution is in liquidation of the distributee partner's entire interest in the partnership. However, section 751(b) applies only to the extent that a partner either receives section 751 property in exchange for his relinquishing any part of his interest in other property, or receives other property in exchange for his relinquishing any part of his interest in section 751 property.

(ii) Section 751(b) does not apply to a distribution to a partner which is not in exchange for his interest in other partnership property. Thus, section 751(b) does not apply to the extent that a distribution consists of the distributee partner's share of section 751 property or his share of other property. Similarly, section 751(b) does not apply to current drawings or to advances against the partner's distributive share, or to a distribution which is, in fact, a gift or payment for services or for the use of capital. In determining whether a partner has received only his share of either section 751 property or of other property, his interest in such property remaining in the partnership immediately after a distribution must be taken into account. For example, the section 751 property in partnership ABC has a fair market value of \$100,000 in which partner A has an interest of 30 percent, or \$30,000. If A receives \$20,000 of section 751 property in a distribution, and continues to have a 30-percent interest in the \$80,000 of section 751 property remaining in the partnership after the distribution, only \$6,000 (\$30,000 minus \$24,000 (30 percent of

\$80,000)) of the section 751 property received by him will be considered to be his share of such property. The remaining \$14,000 (\$20,000 minus \$6,000) received is in excess of his share.

(iii) If a distribution is, in part, a distribution of the distributee partner's share of section 751 property, or of other property (including money) and, in part, a distribution in exchange of such properties, the distribution shall be divided for the purpose of applying section 751(b). The rules of section 751(b) shall first apply to the part of the distribution treated as a sale or exchange of such properties, and then the rules of sections 731 through 736 shall apply to the part of the distribution not treated as a sale or exchange. See paragraph (b)(4)(ii) of this section for treatment of payments under section 736(a).

(2) *Distribution of section 751 property (unrealized receivables or substantially appreciated inventory items).* (i) To the extent that a partner receives section 751 property in a distribution in exchange for any part of his interest in partnership property (including money) other than section 751 property, the transaction shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the income or loss to the partnership will be measured by the difference between the adjusted basis to the partnership of the section 751 property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in other partnership property which he relinquished in the exchange. In computing the partners' distributive shares of such ordinary income or loss, the income or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes gain or loss measured by the difference between his adjusted basis for the prop-

erty relinquished in the exchange (including any special basis adjustment which he may have) and the fair market value of the section 751 property received by him in exchange for his interest in other property which he has relinquished. The distributee's adjusted basis for the property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b). The character of the gain or loss to the distributee partner shall be determined by the character of the property in which he relinquished his interest.

(3) *Distribution of partnership property other than section 751 property.* (i) To the extent that a partner receives a distribution of partnership property (including money) other than section 751 property in exchange for any part of his interest in section 751 property of the partnership, the distribution shall be treated as a sale or exchange of such properties between the distributee partner and the partnership (as constituted after the distribution).

(ii) At the time of the distribution, the partnership (as constituted after the distribution) realizes gain or loss on the sale or exchange of the property other than section 751 property. The amount of the gain to the partnership will be measured by the difference between the adjusted basis to the partnership of the distributed property considered as sold to or exchanged with the partner, and the fair market value of the distributee partner's interest in section 751 property which he relinquished in the exchange. The character of the gain or loss to the partnership is determined by the character of the distributed property treated as sold or exchanged by the partnership. In computing the partners' distributive shares of such gain or loss, the gain or loss shall be allocated only to partners other than the distributee and separately taken into account under section 702(a)(8).

(iii) At the time of the distribution, the distributee partner realizes ordinary income or loss on the sale or exchange of the section 751 property. The amount of the distributee partner's income or loss shall be measured by the difference between his adjusted basis for the section 751 property relinquished in the exchange (including any special basis adjustment which he may have), and the fair market value of other property (including money) received by him in exchange for his interest in the section 751 property which he has relinquished. The distributee partner's adjusted basis for the section 751 property relinquished is the basis such property would have had under section 732 (including subsection (d) thereof) if the distributee partner had received such property in a current distribution immediately before the actual distribution which is treated wholly or partly as a sale or exchange under section 751(b).

(4) *Exceptions.* (i) Section 751(b) does not apply to the distribution to a partner of property which the distributee partner contributed to the partnership. The distribution of such property is governed by the rules set forth in sections 731 through 736, relating to distributions by a partnership.

(ii) Section 751(b) does not apply to payments made to a retiring partner or to a deceased partner's successor in interest to the extent that, under section 736(a), such payments constitute a distributive share of partnership income or guaranteed payments. Payments to a retiring partner or to a deceased partner's successor in interest for his interest in unrealized receivables of the partnership in excess of their partnership basis, including any special basis adjustment for them to which such partner is entitled, constitute payments under section 736(a) and, therefore, are not subject to section 751(b). However, payments under section 736(b) which are considered as made in exchange for an interest in partnership property are subject to section 751(b) to the extent that they involve an exchange of substantially appreciated inventory items for other property. Thus, payments to a retiring partner or to a deceased partner's successor in interest under section 736

must first be divided between payments under section 736(a) and section 736(b). The section 736(b) payments must then be divided, if there is an exchange of substantially appreciated inventory items for other property, between the payments treated as a sale or exchange under section 751(b) and payments treated as a distribution under sections 731 through 736. See subparagraph (1)(iii) of this paragraph, and section 736 and § 1.736-1.

(5) *Statement required.* A partnership which distributes section 751 property to a partner in exchange for his interest in other partnership property, or which distributes other property in exchange for any part of the partner's interest in section 751 property, shall submit with its return for the year of the distribution a statement showing the computation of any income, gain, or loss to the partnership under the provisions of section 751(b) and this paragraph. The distributee partner shall submit with his return a statement showing the computation of any income, gain, or loss to him. Such statement shall contain information similar to that required under paragraph (a)(3) of this section.

(c) *Unrealized receivables.* (1) The term *unrealized receivables*, as used in subchapter K, chapter 1 of the Code, means any rights (contractual or otherwise) to payment for:

(i) Goods delivered or to be delivered (to the extent that such payment would be treated as received for property other than a capital asset), or

(ii) Services rendered or to be rendered,

to the extent that income arising from such rights to payment was not previously includible in income under the method of accounting employed by the partnership. Such rights must have arisen under contracts or agreements in existence at the time of sale or distribution, although the partnership may not be able to enforce payment until a later time. For example, the term includes trade accounts receivable of a cash method taxpayer, and rights to payment for work or goods begun but incomplete at the time of the sale or distribution.

(2) The basis for such unrealized receivables shall include all costs or expenses attributable thereto paid or accrued but not previously taken into account under the partnership method of accounting.

(3) In determining the amount of the sale price attributable to such unrealized receivables, or their value in a distribution treated as a sale or exchange, any arm's length agreement between the buyer and the seller, or between the partnership and the distributee partner, will generally establish the amount or value. In the absence of such an agreement, full account shall be taken not only of the estimated cost of completing performance of the contract or agreement, but also of the time between the sale or distribution and the time of payment.

(4)(i) With respect to any taxable year of a partnership ending after September 12, 1966 (but only in respect of expenditures paid or incurred after that date), the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from mining property defined in section 617(f)(2). With respect to each item of partnership mining property so defined, the potential gain is the amount that would be treated as gain to which section 617(d)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(ii) With respect to sales, exchanges, or other dispositions after December 31, 1975, in any taxable year of a partnership ending after that date, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in a DISC as described in section 992(a). With respect to stock in such a DISC, the potential gain is the amount that would be treated as gain to which section 995(c) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(iii) With respect to any taxable year of a partnership beginning after December 31, 1962, the term *unrealized re-*

ceivables, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1245 property. With respect to each item of partnership section 1245 property (as defined in section 1245(a)(3)), potential gain from section 1245 property is the amount that would be treated as gain to which section 1245(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1245 property were sold by the partnership at its fair market value. See § 1.1245-1(e)(1). For example, if a partnership would recognize under section 1245(a)(1) gain of \$600 upon a sale of one item of section 1245 property and gain of \$300 upon a sale of its only other item of such property, the potential section 1245 income of the partnership would be \$900.

(iv) With respect to transfers after October 9, 1975, and to sales, exchanges, and distributions taking place after that date, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from stock in certain foreign corporations as described in section 1248. With respect to stock in such a foreign corporation, the potential gain is the amount that would be treated as gain to which section 1248(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the stock were sold by the partnership at its fair market value.

(v) With respect to any taxable year of a partnership ending after December 31, 1963, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from section 1250 property. With respect to each item of partnership section 1250 property (as defined in section 1250(c)), potential gain from section 1250 property is the amount that would be treated as gain to which section 1250(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item of section 1250 property were sold by the partnership at its fair market value. See § 1.1250-1(f)(1).

(vi) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm recapture property as defined in section 1251(e)(1) (as in effect before enactment of the Tax Reform Act of 1984). With respect to each item of partnership farm recapture property so defined, the potential gain is the amount which would be treated as gain to which section 1251(c) (as in effect before enactment of the Tax Reform Act of 1984) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(vii) With respect to any taxable year of a partnership beginning after December 31, 1969, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from farm land as defined in section 1252(a)(2). With respect to each item of partnership farm land so defined, the potential gain is the amount that would be treated as gain to which section 1252(a)(1) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the item were sold by the partnership at its fair market value.

(viii) With respect to transactions which occur after December 31, 1976, in any taxable year of a partnership ending after that date, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes potential gain from franchises, trademarks, or trade names referred to in section 1253(a). With respect to each such item so referred to in section 1253(a), the potential gain is the amount that would be treated as gain to which section 1253(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the items were sold by the partnership at its fair market value.

(ix) With respect to any taxable year of a partnership ending after December 31, 1975, the term *unrealized receivables*, for purposes of this section and sections 731, 736, 741, and 751, also includes

potential gain under section 1254(a) from natural resource recapture property as defined in § 1.1254-1(b)(2). With respect to each separate partnership natural resource recapture property so described, the potential gain is the amount that would be treated as gain to which section 1254(a) would apply if (at the time of the transaction described in section 731, 736, 741, or 751, as the case may be) the property were sold by the partnership at its fair market value.

(x) For purposes of section 751(c) and this paragraph (c)(4), any arm's-length agreement between the buyer and seller, or between the partnership and distributee partner, will generally establish the fair market value of the property described in this paragraph (c)(4).

(5) For purposes of subtitle A of the Internal Revenue Code, the basis of any potential gain described in paragraph (c)(4) of this section is zero.

(6)(i) If (at the time of any transaction referred to in paragraph (c)(4) of this section) a partnership holds property described in paragraph (c)(4) of this section and if—

(A) A partner had a special basis adjustment under section 743(b) in respect of the property;

(B) The basis under section 732 of the property if distributed to the partner would reflect a special basis adjustment under section 732(d); or

(C) On the date a partner acquired a partnership interest by way of a sale or exchange (or upon the death of another partner) the partnership owned the property and an election under section 754 was in effect with respect to the partnership, the partner's share of any potential gain described in paragraph (c)(4) of this section is determined under paragraph (c)(6)(ii) of this section.

(ii) The partner's share of the potential gain described in paragraph (c)(4) of this section in respect of the property to which this paragraph (c)(6)(ii) applies is that amount of gain that the partner would recognize under section 617(d)(1), 995(c), 1245(a), 1248(a), 1250(a), 1251(c) (as in effect before the Tax Reform Act of 1984), 1252(a), 1253(a), or 1254(a) (as the case may be) upon a sale

of the property by the partnership, except that, for purposes of this paragraph (c)(6) the partner's share of such gain is determined in a manner that is consistent with the manner in which the partner's share of partnership property is determined; and the amount of a potential special basis adjustment under section 732(d) is treated as if it were the amount of a special basis adjustment under section 743(b). For example, in determining, for purposes of this paragraph (c)(6), the amount of gain that a partner would recognize under section 1245 upon a sale of partnership property, the items allocated under § 1.1245-1(e)(3)(ii) are allocated to the partner in the same manner as the partner's share of partnership property is determined. See § 1.1250-1(f) for rules similar to those contained in § 1.1245-1(e)(3)(ii).

(d) *Inventory items which have substantially appreciated in value*—(1) *Substantial appreciation*. Partnership inventory items shall be considered to have appreciated substantially in value if, at the time of the sale or distribution, the total fair market value of all the inventory items of the partnership exceeds 120 percent of the aggregate adjusted basis for such property in the hands of the partnership (without regard to any special basis adjustment of any partner) and, in addition, exceeds 10 percent of the fair market value of all partnership property other than money. The terms "inventory items which have appreciated substantially in value" or "substantially appreciated inventory items" refer to the aggregate of all partnership inventory items. These terms do not refer to specific partnership inventory items or to specific groups of such items. For example, any distribution of inventory items by a partnership the inventory items of which as a whole are substantially appreciated in value shall be a distribution of substantially appreciated inventory items for the purposes of section 751(b), even though the specific inventory items distributed may not be appreciated in value. Similarly, if the aggregate of partnership inventory items are not substantially appreciated in value, a distribution of specific inventory items, the value of which is more than 120 percent of their

adjusted basis, will not constitute a distribution of substantially appreciated inventory items. For the purpose of this paragraph, the "fair market value" of inventory items has the same meaning as "market" value in the regulations under section 471, relating to general rule for inventories.

(2) *Inventory items*. The term *inventory items* as used in subchapter K, chapter 1 of the Code, includes the following types of property:

(i) Stock in trade of the partnership, or other property of a kind which would properly be included in the inventory of the partnership if on hand at the close of the taxable year, or property held by the partnership primarily for sale to customers in the ordinary course of its trade or business. See section 1221(l).

(ii) Any other property of the partnership which, on sale or exchange by the partnership, would be considered property other than a capital asset and other than property described in section 1231. Thus, accounts receivable acquired in the ordinary course of business for services or from the sale of stock in trade constitute inventory items (see section 1221(4)), as do any unrealized receivables.

(iii) Any other property retained by the partnership which, if held by the partner selling his partnership interest or receiving a distribution described in section 751(b), would be considered property described in subdivision (i) or (ii) of this subparagraph. Property actually distributed to the partner does not come within the provisions of section 751(d)(2)(C) and this subdivision.

(e) *Section 751 property and other property*. For the purposes of this section, *section 751 property* means unrealized receivables or substantially appreciated inventory items, and *other property* means all property (including money) except section 751 property.

(f) *Effective date*. Section 751 applies to gain or loss to a seller, distributee, or partnership in the case of a sale, exchange, or distribution occurring after March 9, 1954. For the purpose of applying this paragraph in the case of a taxable year beginning before January 1, 1955, a partnership or a partner may elect to treat as applicable any other section of subchapter K, chapter 1 of

the Code. Any such election shall be made by a statement submitted not later than the time prescribed by law for the filing of the return for such taxable year, or August 21, 1956, whichever date is later (but not later than 6 months after the time prescribed by law for the filing of the return for such year). See section 771(b)(3) and paragraph (b)(3) of § 1.771-1. See also section 771(c) and paragraph (c) of § 1.771-1.

(g) *Examples.* Application of the provisions of section 751 may be illustrated by the following examples:

Example 1. C buys B's interest in personal service partnership AB for \$15,000, when the balance sheet of the firm (reflecting a cash receipts and disbursements method of accounting) is as follows:

ASSETS		
	Adjusted basis per books	Market value
Cash	\$3,000	\$3,000
Loans receivable	10,000	10,000
Other assets	7,000	7,000
Unrealized receivables	0	12,000
Total	20,000	32,000

LIABILITIES AND CAPITAL		
	Per books	Value
Liabilities	\$2,000	\$2,000
Capital:		
A	9,000	15,000
B	9,000	15,000
Total	20,000	32,000

Section 751(a) applies to the sale. The total amount realized by B is \$16,000, consisting of the cash received, \$15,000, plus \$1,000, B's share of the partnership liabilities assumed by C. See section 752. B's undivided half interest in the partnership property includes a half-interest in the partnership's unrealized receivables which are worth \$12,000. Consequently, \$6,000 of the \$16,000 realized by B shall be considered received in exchange for B's interest in the partnership attributable to its unrealized receivables. The remaining \$10,000 realized by B is in exchange for a capital asset. B's basis for his partnership interest is \$10,000 (\$9,000, plus \$1,000, B's share of partnership liabilities). No portion of this basis is attributable to B's share of the unrealized receivables of the partnership since such property has a zero basis in the hands of the partnership; therefore, B has a basis of zero for the unrealized receivables because the partnership basis for such receivables would have carried over to him under section 732 had they been distributed to him. The difference between the zero basis and the \$6,000 B realized for the unrealized receivables is ordinary income to him. The entire \$10,000 of B's basis is the basis for his interest in partnership property other than unrealized receivables and is applied against the remaining \$10,000 (\$16,000 minus \$6,000) received from the sale of his interest. Therefore, B has no capital gain or loss. (If B's basis for his interest in partnership property, other than unrealized receivables, were \$9,000, he would realize capital gain of \$1,000. If his basis were \$11,000, he would sustain a capital loss of \$1,000).

Example 2. (a) *Facts.* Partnership ABC makes a distribution to partner C in liquidation of his entire one-third interest in the partnership. At the time of the distribution, the balance sheet of the partnership, which uses the accrual method of accounting, is as follows:

ASSETS		
	Adjusted basis per books	Market value
Cash	\$15,000	\$15,000
Accounts receivable	9,000	9,000
Inventory	21,000	30,000
Depreciable property	42,000	48,000
Land	9,000	9,000
Total	96,000	11,000

LIABILITIES AND CAPITAL		
	Per books	Value
Current liabilities	\$15,000	\$15,000
Mortgage payable	21,000	21,000
Capital:		
A	20,000	25,000
B	20,000	25,000

LIABILITIES AND CAPITAL—Continued

	Per books	Value
C	20,000	25,000
Total	96,000	111,000

The distribution received by C consists of \$10,000 cash and depreciable property with a fair market value of \$15,000 and an adjusted basis to the partnership of \$15,000.

(b) *Presence of section 751 property.* The partnership has no unrealized receivables, but the dual test provided in section 751(d)(1) must be applied to determine whether the inventory items of the partnership, in the aggregate, have appreciated substantially in value. The fair market value of all partnership inventory items, \$39,000 (inventory \$30,000, and accounts receivable \$9,000), exceeds 120 percent of the \$30,000 adjusted basis of such items to the partnership. The fair market value of the inventory items, \$39,000, also exceeds 10 percent of the fair market value of all partnership property other than money (10 percent of \$96,000 or \$9,600). Therefore, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* Since C's entire partnership interest is to be liquidated, the provisions of section 736 are applicable. No part of the payment, however, is considered as a distributive share or as a guaranteed payment under section 736(a) because the entire payment is made for C's interest in partnership property. Therefore, the entire payment is for an interest in partnership property under section 736(b), and, to the extent applicable, subject to the rules of section 751. In the distribution, C received his share of cash (\$5,000) and \$15,000 in depreciable property (\$1,000 less than his \$16,000 share). In addition, he received other partnership property (\$5,000 cash and \$12,000 liabilities assumed, treated as money distributed under section 752(b)) in exchange for his interest in accounts receivable (\$3,000), inventory (\$10,000), land (\$3,000), and the balance of his interest in depreciable property (\$1,000). Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., inventory items, which include trade accounts receivable). The section 751 property exchanged has a fair market value of \$13,000 (\$3,000 in accounts receivable and \$10,000 in inventory). Thus, \$13,000 of the total amount C received is considered as received for the sale of section 751 property.

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C's share of the inventory items is treated as if he received them in a current distribution, and his basis for such items is \$10,000 (\$7,000

for inventory and \$3,000 for accounts receivable) as determined under paragraph (b)(3)(iii) of this section. Then C is considered as having sold his share of inventory items to the partnership for \$13,000. Thus, on the sale of his share of inventory items, C realizes \$3,000 of ordinary income.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was \$32,000 (\$20,000 plus \$12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by \$10,000, the basis attributed to the section 751 property treated as distributed to C and sold by him to the partnership. Thus, C has a basis of \$22,000 for the remainder of his partnership interest. The total distribution to C was \$37,000 (\$22,000 in cash and liabilities assumed, and \$15,000 in depreciable property). Since C received no more than his share of the depreciable property, none of the depreciable property constitutes proceeds of the sale under section 751(b). C did receive more than his share of money. Therefore, the sale proceeds, treated separately in subparagraph (1) of this paragraph of this example, must consist of money and therefore must be deducted from the money distribution. Consequently, in liquidation of the balance of C's interest, he receives depreciable property and \$9,000 in money (\$22,000 less \$13,000). Therefore, no gain or loss is recognized to C on the distribution. Under section 732(b), C's basis for the depreciable property is \$13,000 (the remaining basis of his partnership interest, \$22,000, reduced by \$9,000, the money received in the distribution).

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has no ordinary income on the distribution since it did not give up any section 751 property in the exchange. Of the \$22,000 money distributed (in cash and the assumption of C's share of liabilities), \$13,000 was paid to acquire C's interest in inventory (\$10,000 fair market value) and in accounts receivable (\$3,000). Since under section 751(b) the partnership is treated as buying these properties, it has a new cost basis for the inventory and accounts receivable acquired from C. Its basis for C's share of inventory and accounts receivable is \$13,000, the amount which the partnership is considered as having paid C in the exchange. Since the partnership is treated as having distributed C's share of inventory and accounts receivable to him, the partnership must decrease its basis for inventory and accounts receivable (\$30,000) by \$10,000, the basis of C's share treated as distributed to him, and then increase the basis for inventory and accounts receivable by \$13,000 to reflect the purchase

prices of the items acquired. Thus, the basis of the partnership inventory is increased from \$21,000 to \$24,000 in the transaction. (Note that the basis of property acquired in a section 751(b) exchange is determined under section 1012 without regard to any elections of the partnership. See paragraph (e) of § 1.732-1.) Further, the partnership realizes no capital gain or loss on the portion of the distribution treated as a sale under section 751(b) since, to acquire C's interest in the inventory and accounts receivable, it gave up money and assumed C's share of liabilities.

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not in exchange for C's interest in section 751 property, C received only other property as follows: \$15,000 in depreciable property (with a basis to the partnership of \$15,000) and \$9,000 in money (\$22,000 less \$13,000 treated under subparagraph (1) of this paragraph of this example). Since this part of the distribution is not an exchange of section 751 property for other property, section 751(b) does not apply. Instead, the provisions which apply are sections 731 through 736, relating to distributions by a partnership. No gain or loss is recognized to the partnership on the distribution. (See section 731(b).) Further, the partnership makes no adjustment to the basis of remaining depreciable property unless an election under section 754 is in effect. (See section 734(a).) Thus, the basis of the depreciable property before the distribution, \$42,000, is reduced by the basis of the depreciable property distributed, \$15,000, leaving a basis for the depreciable property in the partnership of \$27,000. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) as follows: Since the adjusted basis of the distributed property to the partnership had been \$15,000, and is only \$13,000 in C's hands (see paragraph (d)(2) of this example), the partnership will increase the basis of the depreciable property remaining in the partnership by \$2,000 (the excess of the adjusted basis to the partnership of the distributed depreciable property immediately before the distribution over its basis to the distributee). Whether or not an election under section 754 is in effect, the basis for each of the remaining partner's partnership interests will be \$38,000 (\$20,000 original contribution, plus \$12,000, each partner's original share of the liabilities, plus \$6,000, the share of C's liabilities each assumed).

(f) *Partnership trial balance.* A trial balance of the AB partnership after the distribution in liquidation of C's entire interest would reflect the results set forth in the schedule below. Column I shows the amounts to be reflected in the records if an election is in effect under section 754 with respect to an optional adjustment under section 734(b) to the

basis of undistributed partnership property. Column II shows the amounts to be reflected in the records where an election under section 754 is not in effect. Note that in column II, the total bases for the partnership assets do not equal the total of the bases for the partnership interests.

Example 3. (a) Facts. Assume that the distribution to partner C in example 2 of this paragraph in liquidation of his entire interest in partnership ABC consists of \$5,000 in cash and \$20,000 worth of partnership inventory with a basis of \$14,000.

	I		II	
	Sec. 754, Election in effect		Sec. 754, Election not in effect	
	Basis	Fair market value	Basis	Fair market value
Cash	\$5,000	\$5,000	\$5,000	\$5,000
Accounts receivable	9,000	9,000	9,000	9,000
Inventory	24,000	30,000	24,000	30,000
Depreciable property	29,000	33,000	27,000	33,000
Land	9,000	9,000	9,000	9,000
	76,000	86,000	74,000	86,000
Current liabilities	15,000	15,000	15,000	15,000
Mortgage	21,000	21,000	21,000	21,000
Capital:				
.....	20,000	25,000	20,000	25,000
.....	20,000	25,000	20,000	25,000
	76,000	86,000	76,000	86,000

(b) *Presence of section 751 property.* For the same reason as stated in paragraph (b) of example 2, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* In the distribution, C received his share of cash (\$5,000) and his share of appreciated inventory items (\$13,000). In addition, he received appreciated inventory with a fair market value of \$7,000 (and with an adjusted basis to the partnership of \$4,900) and \$12,000 in money (liabilities assumed). C has relinquished his interest in \$16,000 of depreciable property and \$3,000 of land. Although C relinquished his interest in \$3,000 of accounts receivable, such accounts receivable are inventory items and, therefore, that exchange was not an exchange of section 751 property for other property. Section 751(b) applies only to the extent of the exchange of other property for section 751 property (i.e., depreciable property or land for inventory items). Assume that the partners agree that the \$7,000 of inventory in excess of C's share was received by him in exchange for \$7,000 of depreciable property.

(d) *Distributee partner's tax consequences.* C's tax consequence on the distributions are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/16ths share of the depreciable property in a current distribution. His basis for that share is \$6,125 (\$20,000/48,000 of \$7,000), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/16ths share of depreciable property to the partnership for \$7,000, realizing a gain of \$875.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution, C's basis for his partnership interest was \$32,000 (\$20,000, plus \$12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by \$6,125, the basis of property treated as distributed to C and sold by him to the partnership. Thus, C will have a basis of \$25,875 for the remainder of his partnership interest. Of the \$37,000 total distribution to C, \$30,000 (\$17,000 in money, including liabilities assumed, and \$13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory with a fair market value of \$13,000 (which had an adjusted basis to the partnership of \$9,100) is limited to \$8,875, the amount of the remaining basis for his partnership interest, \$25,875, reduced by \$17,000, the money received. Thus, C's total aggregate basis for the inventory received is \$15,875 (\$7,000 plus \$8,875), and not its \$14,000 basis in the hands of the partnership.

(e) *Partnership's tax consequences.* The tax consequences to the partnership on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* The partnership consisting of the remaining members has \$2,100 of ordinary income on the sale of the \$7,000 of inventory which had a basis to the partnership of \$4,900 (\$21,000/30,000 of \$7,000). This \$7,000 of inventory was paid to acquire 7/16ths of C's interest in the depreciable property. Since, under section 751(b), the partnership is treated as buying this property from C, it has a new cost basis for such property. Its basis for the depreciable property is \$42,875 (\$42,000 less \$6,125, the basis of the 7/16ths share considered as distributed to C, plus \$7,000, the partnership purchase price for this share).

(2) *The part of the distribution not under section 751(b).* In the remainder of the distribution to C which was not a sale or exchange of section 751 property for other property, the partnership realizes no gain or loss. See section 731(b). Further, under section 734(a), the partnership makes no adjustment to the basis of the accounts receivable or the 9/16ths interest in depreciable property which C relinquished. However, if an election under section 754 is in effect, the partnership must make the adjustment required under section 734(b) since the adjusted basis to the partnership of the inventory distributed had been \$9,100, and C's basis for such inventory after distribution is only \$8,875. The basis of the

inventory remaining in the partnership must be increased by \$225. Whether or not an election under section 754 is in effect, the basis for each of the remaining partnership interests will be \$39,050 (\$20,000 original contribution, plus \$12,000, each partner's original share of the liabilities, plus \$6,000, the share of C's liabilities now assumed, plus \$1,050, each partner's share of ordinary income realized by the partnership upon that part of the distribution treated as a sale or exchange).

Example 4. (a) *Facts.* Assume the same facts as in example 3 of this paragraph, except that the partners did not identify the property which C relinquished in exchange for the \$7,000 of inventory which he received in excess of his share.

(b) *Presence of section 751 property.* For the same reasons stated in paragraph (b) of example 2 of this paragraph, the partnership inventory items have substantially appreciated in value.

(c) *The properties exchanged.* The analysis stated in paragraph (c) of example 3 of this paragraph is the same in this example, except that, in the absence of a specific agreement among the partners as to the properties exchanged, C will be presumed to have sold to the partnership a proportionate amount of each property in which he relinquished an interest. Thus, in the absence of an agreement, C has received \$7,000 of inventory in exchange for his release of 7/19ths of the depreciable property and 7/19ths of the land. (\$7,000, fair market value of property released, over \$19,000, the sum of the fair market values of C's interest in the land and C's interest in the depreciable property.)

(d) *Distributee partner's tax consequences.* C's tax consequences on the distribution are as follows:

(1) *The section 751(b) sale or exchange.* C is treated as if he had received his 7/19ths shares of the depreciable property and land in a current distribution. His basis for those shares is \$6,263 (\$1,000/57,000 of \$7,000, their fair market value), as determined under paragraph (b)(2)(iii) of this section. Then C is considered as having sold his 7/19ths shares of depreciable property and land to the partnership for \$7,000, realizing a gain of \$737.

(2) *The part of the distribution not under section 751(b).* Section 751(b) does not apply to the balance of the distribution. Before the distribution C's basis for his partnership interest was \$32,000 (\$20,000 plus \$12,000, his share of partnership liabilities). See section 752(a). This basis is reduced by \$6,263, the bases of C's shares of depreciable property and land treated as distributed to him and sold by him to the partnership. Thus, C will have a basis of \$25,737 for the remainder of his partnership interest. Of the total \$37,000 distributed to C, \$30,000 (\$17,000 in money, including liabilities assumed, and \$13,000 in inventory) is not within section 751(b). Under section 732(b), C's basis for the inventory